

FOMC Briefing
Michael J. Prell
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I thought I might begin by recounting an interesting experience I had last week. At a dinner for new Reserve Bank directors, I found myself sitting between a small-town banker and a big city industrialist. They were carrying on a debate that captured nicely some of the issues before you today.

The banker started by saying that the businesses he'd been talking with were reporting that labor markets had gotten really tight and that they were granting bigger pay increases and intended to pass their higher costs along in price hikes. He thought that a Fed tightening step now would reduce the risks of greater pain later. The industrialist then proceeded to recount how his firm was requiring suppliers to trim prices year after year and was telling workers that, if they didn't like taking lump sum payments in lieu of base-pay increases, the company would just move operations to Utah or Mexico; in his view, there was no risk of a pickup in inflation in this new, open economy where the Internet gives firms and customers instant information about the best prices--and even what is tantamount to an electronic auction market. From his perspective, real interest rates are already high and an increase would needlessly sacrifice opportunities for real growth.

I suppose that one would have to characterize our Greenbook forecast as being more aligned with the banker's traditional view than with the industrialist's "new age" view. We take that position with some nervousness, but I must emphasize that our nervousness isn't one-sided. For, while we grant that the industrialist has a point, we also see grounds for worrying that we may be entering a more inflationary boom than is described in our baseline scenario.

On the latter score, it's clear that the economy has been quite strong thus far this year. Moreover, one is hard-pressed to identify any imminent threats to at least moderate growth in coming quarters. To be sure, the January trade figures, which came out after the Greenbook was completed, were quite weak--but that was basically confirmation of our projection for the sector. Meanwhile, there's no inventory overhang to damp production in the near term. The recent

surge in consumer demand appears to have been supported mainly by rapid increases in jobs and labor income; people have not had to drain their savings accounts and, instead, wealth has continued to accumulate.

It doesn't take much of a stretch of the imagination to transmute these comments regarding the limited risks of a major shortfall in growth into a description of a meaningful economic boom. Although the stock market has been wavering of late, we wouldn't rule out the possibility that share prices might move appreciably higher; there's still a lot of liquidity, as the commentators say. And, while we're not uncomfortable with the notion that people will tend to keep their capital gains tucked away for future college tuitions or retirement, it's not hard to envision their opening their purses a bit wider for current consumption or to buy a bigger residence or a vacation home. Stronger household spending would in turn have accelerator effects on business fixed investment--which might, in any event, be driven to higher levels than we've forecast by the rapid obsolescence of existing equipment and the incipient wave of enthusiasm in office and hotel construction. And, of course, any greater strength in final demand is likely to generate pressures to build inventories more substantially.

All things considered, then, we think that it's quite reasonable for you to factor into your thinking the notion that it probably will require at least some tightening of financial conditions to rein in aggregate demand and prevent resource utilization rates--particularly labor utilization--from moving appreciably higher. But that leads to the other key question for policy: Need one be concerned about higher utilization, or should one stay on the sidelines and applaud it?

As you know, we're projecting only a mild further acceleration of compensation over the course of 1997 and '98. And we have the core CPI accelerating but a smidge this year and then only to 3-1/4 percent in 1998. Still, this is a change in the direction of the underlying trend, and it implies the risk of a building inflationary momentum over time that might necessitate a more wrenching correction to halt.

It's certainly possible that we're being too pessimistic about inflation, but we don't see it as probable that we're way off

the mark in the broad sweep of our assessment. Perhaps even in a tighter labor market, workers would be sufficiently intimidated by the risk of jobs being moved that they wouldn't seek a bigger piece of the pie. That hypothesis seems difficult to maintain, however, in the face of indications that wages have in fact been accelerating. And there are only so many people in Utah willing to work at the currently prevailing wage. Although a strong dollar might make substitution of foreign workers or suppliers a more attractive alternative than we've anticipated, one wonders how far that process can go before the international financial markets become uneasy about mounting U.S. trade deficits; indeed, we have built in some downward pressures on the dollar on these grounds.

If one discounts that story, then, stable inflation with tighter labor markets would appear to require either that firms give up some of their profits to workers or that they accelerate their productivity improvements. There may be hints of a squeeze on profitability in the occasional anecdote, but on the whole, to date, there is not much to suggest that this phenomenon has taken on macro-significance. Nonetheless, our forecast does anticipate that the erosion of margins will become important in damping the transmission of rising unit labor costs to prices.

More interesting, perhaps, is the latter possibility--that is, that productivity gains can be enlarged. One might think that the opportunities in this regard would diminish cyclically, but there is some hint in the recent behavior of wages, prices, and profits that firms may have found ways of stepping up their pace of productivity improvement. Perhaps this is a sign that firms are now reaping the benefits of technology investments that seemed to be eluding them earlier. Optimism in this regard has not proven particularly wise in the past, but we have in a sense made a small allowance for a productivity boost by forecasting increases in output per hour in 1997-98 that considerably exceed the measured average of the past several years--a pattern that runs counter to what might be expected on the basis of cyclical norms.

In short, we may be in a new age, but we don't yet find compelling evidence that we should toss into the wastebasket our fundamental framework of analysis. We've made adjustments over the past year--for example, by lowering our NAIRU assumption and by

discounting the published weak productivity figures--to take what we hope is judicious account of the surprises we've been experiencing in the behavior of inflation. Thus, we feel our forecast presents a reasonably balanced picture of the prospects for inflation, should growth follow the course we've predicted.

The bottom line is that, if you're feeling uncomfortably uncertain, we're definitely sharing your pain. Nonetheless, we do believe that the Greenbook is on pretty solid ground in suggesting that policy tightening is likely to be needed at some point to avert an upturn in inflation.